

Educational Enhancement Funding Corporation

**2011
ANNUAL
REPORT**

EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
2011 ANNUAL REPORT

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A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
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For the Year Ended June 30, 2011

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EDUCATIONAL ENHANCEMENT FUNDING CORPORATION

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Pierre, South Dakota 57501
605-224-9200

CORPORATION DIRECTORS

Thomas W. Graham,
Chairman

Douglas J. Hajek

Dennis Haan,
Vice Chairman

Joseph E. Lien

D.J. Mertens,
Secretary

Dennis H. Neugebauer

Ken Karels

James C. Roby

James C. Spies

CORPORATION STAFF

Executive Secretary

Donald A. Templeton

CORPORATION COUNSEL

Todd Meierhenry
Danforth & Meierhenry, L.L.P.
Sioux Falls, South Dakota



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MARTIN L. GUINDON, CPA
AUDITOR GENERAL

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS

The Honorable Dennis Daugaard
Governor of South Dakota

and

Board of Directors
Educational Enhancement Funding Corporation

We have audited the financial statements of the Educational Enhancement Funding Corporation as of and for the fiscal year ended June 30, 2011 and have issued our report thereon dated January 17, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Educational Enhancement Funding Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Educational Enhancement Funding Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Educational Enhancement Funding Corporation's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies

in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Educational Enhancement Funding Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management and members of the South Dakota Legislature and is not intended to be and should not be used by anyone other than those specified. However, this report is a matter of public record and its distribution is not limited.

A handwritten signature in black ink, appearing to read "Martin L. Guindon", with a stylized flourish at the end.

Martin L. Guindon, CPA
Auditor General

January 17, 2012



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MARTIN L. GUINDON, CPA
AUDITOR GENERAL

INDEPENDENT AUDITOR'S REPORT

The Honorable Dennis Daugaard
Governor of South Dakota

and

Board of Directors
Educational Enhancement Funding Corporation

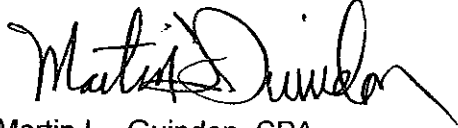
We have audited the accompanying financial statements of the Educational Enhancement Funding Corporation, a component unit of the State of South Dakota, as of and for the fiscal year ended June 30, 2011, as listed in the table of contents. These financial statements are the responsibility of the Educational Enhancement Funding Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Educational Enhancement Funding Corporation as of June 30, 2011, and the changes in financial position and its cash flows for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 17, 2012 on our consideration of Educational Enhancement Funding Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 8 through 10 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in black ink, appearing to read "Martin L. Guindon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Martin L. Guindon, CPA
Auditor General

January 17, 2012

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2011

This section of the Educational Enhancement Funding Corporation (the "Corporation") annual financial report presents management's discussion and analysis of the Corporation's financial performance during the fiscal year ended June 30, 2011 (FY 2011). This analysis should be read in conjunction with the Independent Auditor's Report, financial statements and notes to the financial statements.

Financial Highlights

- Total assets of the Corporation decreased \$1.0 million or (2.1)%.
- Total liabilities of the Corporation decreased \$11.0 million or (5.2)%.
- Net assets of the Corporation increased \$9.9 million or 6.2%.
- Cash and cash equivalents of the Corporation decreased \$575.7 thousand or (74.6%).
- Investments increased \$460.5 thousand or 1.4%.

Financial Statement Elements

Changes in Assets and Liabilities (in thousands of dollars)

	<u>2011</u>	<u>2010</u>	<u>Dollar Change</u>	<u>% Change</u>
Assets				
Cash and cash equivalents	\$ 195.7	\$ 771.4	\$ (575.7)	(74.6)
Investments	32,735.5	32,275.0	460.5	1.4
Accrued interest	96.9	103.9	(7.0)	(6.7)
Prepaid insurance	7.6	8.0	(.4)	(5.0)
Receivable from Participating Manufacturers	12,002.9	12,767.6	(764.7)	(6.0)
Unamortized bond issuance costs	3,179.4	3,331.4	(152.0)	(4.6)
Total Assets	<u>48,218.0</u>	<u>49,257.3</u>	<u>(1,039.3)</u>	<u>(2.1)</u>
Liabilities and Net Assets				
Liabilities:				
Accounts payable	2.9	0.0	2.9	100.0
Bonds payable	198,498.0	209,483.0	(10,985.0)	(5.2)
Unamortized discount	(1,819.2)	(1,906.2)	87.0	4.6
Accrued interest payable	1,087.9	1,149.3	(61.4)	(5.3)
Total Liabilities	<u>197,769.6</u>	<u>208,726.1</u>	<u>(10,956.5)</u>	<u>(5.2)</u>
Net Assets	<u>(149,551.6)</u>	<u>(159,468.8)</u>	<u>9,917.2</u>	<u>6.2</u>
Total Liabilities and Net Assets	<u>\$ 48,218.0</u>	<u>\$ 49,257.3</u>	<u>(\$ 1,039.3)</u>	<u>(2.1)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2011
(Continued)

Changes in Net Assets
(in thousands of dollars)

	<u>2011</u>	<u>2010</u>	<u>Dollar</u> <u>Change</u>	<u>%</u> <u>Change</u>
Revenues:				
Payments from Participating Manufacturers	\$ 22,907.8	\$ 22,751.0	\$ 156.8	.7
Investment earnings	<u>1,098.4</u>	<u>1,125.9</u>	<u>(27.5)</u>	<u>(2.4)</u>
Total Revenues	24,006.2	23,876.9	129.3	.5
Expenses:				
General and administrative	85.2	89.1	(3.9)	(4.4)
Insurance	52.9	55.2	(2.3)	(4.2)
Amortization	152.0	152.0	0.0	0.0
Bond interest	<u>13,798.9</u>	<u>14,583.3</u>	<u>(784.4)</u>	<u>(5.4)</u>
Total Expenses	<u>14,089.0</u>	<u>14,879.6</u>	<u>(790.6)</u>	<u>(5.3)</u>
Change in Net Assets	<u>\$ 9,917.2</u>	<u>\$ 8,997.3</u>	<u>\$ 919.9</u>	<u>10.2</u>

Analysis:

Principal paid on bonds for FY-11 was \$11.0 million, a \$.7 million decrease over the previous period. Payments from Participating Manufacturers for FY-11 were \$22.9 million, a \$.15 million increase over the previous period. Payments from Participating Manufacturers is in line with the projections as set forth in the Master Settlement Agreement and is further addressed in the footnotes to the financial statements (see Note 6, Contingency 2). Interest paid on bonds for FY-11 was \$13.8 million, a \$.8 million decrease over the previous period.

MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2011
(Continued)

Debt Administration:

The Corporation issued a total of \$148.5 million in taxable and \$129.5 million in tax-exempt bonds in fiscal year 2003. No bonds were issued in fiscal year 2011.

Outstanding bonds payable bear interest at rates ranging from 6.5% to 6.72%. \$0 of regularly scheduled bonds were redeemed and \$10,985,000 of bonds were turbo redeemed during this fiscal year.

The Corporation's bonds are rated BBB by Standard and Poor's and Baa3 by Moody's Investor Service as of June 30, 2011.

More detailed information about the Corporation's debt can be found in Note 3, Long-term Debt.

Overview:

Payments from Participating Manufacturers are the major source of revenue for the Corporation. Future payments are to be used to turbo redeem outstanding bonds.

This report is presented to provide additional information regarding operations of the Corporation and to meet the requirements of GASB Statement No. 34.

In 2007 EEFC was examined by the Internal Revenue Service. Extensive testing was done by the Internal Revenue Service on investment policies, investments and debt service reserve requirements in regards to the 2002A bonds. The examination resulted in no changes in tax exempt status of the 2002A bonds.

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EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF NET ASSETS
June 30, 2011

ASSETS

Current assets:

Cash and cash equivalents	\$ 194,993
Restricted cash and cash equivalents	679
Investments	9,313,893
Restricted investments	23,421,566
Accrued interest receivable	96,855
Prepaid insurance	7,627
Receivable from Participating Manufacturers	12,002,882
Unamortized bond issue costs	<u>152,004</u>
Total current assets	45,190,499

Non-current assets:

Unamortized bond issue costs	<u>3,027,419</u>
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Total Assets	<u>48,217,918</u>
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LIABILITIES

Current liabilities payable from restricted assets:

Accounts payable	2,914
Accrued interest payable	<u>1,087,840</u>
Total current liabilities	<u>1,090,754</u>

Non-current liabilities payable from restricted assets:

Bonds payable – long term, net of unamortized discount	<u>196,678,749</u>
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Total Liabilities	<u>197,769,503</u>
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NET ASSETS

Restricted for Debt Service	23,422,245
Unrestricted (Deficit)	<u>(172,973,830)</u>

TOTAL NET ASSETS (DEFICIT)	<u>\$ (149,551,585)</u>
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The notes to the financial statements are an integral part of this statement.

EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
For the Year Ended June 30, 2011

OPERATING REVENUES

Payments from Participating Manufacturers	\$ 22,907,775
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Total operating revenues	<u>22,907,775</u>
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OPERATING EXPENSES

General and administrative expenses	85,185
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Insurance expense	52,911
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Amortization expense	152,004
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Bond interest expense	<u>13,798,914</u>
-----------------------	-------------------

Total operating expenses	<u>14,089,014</u>
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Operating income	8,818,761
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NONOPERATING REVENUES

Investment earnings	<u>1,098,467</u>
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Change in net assets	9,917,228
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NET ASSETS – Beginning of Year	<u>(159,468,813)</u>
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NET ASSETS – END OF YEAR	<u>\$ (149,551,585)</u>
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The notes to the financial statements are an integral part of this statement.

EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2011

Cash flows from operating activities:		
Receipts from Participating Manufacturers	\$ 23,672,466	
Payments for general expenses	<u>(134,801)</u>	
Net cash provided by operating activities		23,537,665
Cash flows from noncapital financing activities:		
Principal payments on bonds	(10,985,000)	
Interest payments on bonds	<u>(13,773,454)</u>	
Net cash used for noncapital financing activities		(24,758,454)
Cash flows from investing activities:		
Receipts from interest income on investments	1,105,859	
Purchase of investment securities	(73,426,979)	
Proceeds from sale and maturity of investments	<u>72,966,177</u>	
Net cash provided by investing activities		<u>645,057</u>
Net decrease in cash and cash equivalents during the fiscal year		(575,732)
Cash and cash equivalents at beginning of year		<u>771,404</u>
Cash and cash equivalents at end of year		<u>\$ 195,672</u>
Reconciliation of operating income to net cash provided/(used) by operating activities		
Operating income		\$ 8,818,761
Adjustments to reconcile operating income to net cash provided by operating activities		
Amortization expense	152,004	
Interest expense	13,798,915	
Decrease/(increase) in assets:		
Prepaid expense	381	
Receivable from Participating Manufacturers	764,690	
Increase/(decrease) in liabilities:		
Accounts payable	<u>2,914</u>	
Total adjustments		<u>14,718,904</u>
Net cash provided by operating activities		<u>\$ 23,537,665</u>

The notes to the financial statements are an integral part of this statement.

EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2011

**Reconciliation of cash and cash equivalents
to the statement of net assets**

Cash and cash equivalents	\$ 194,993
Restricted cash and cash equivalents	<u>679</u>
Total cash and cash equivalents reported on the Statement of Net Assets	<u>\$ 195,672</u>

The notes to the financial statements are an integral part of this statement.

EDUCATIONAL ENHANCEMENT FUNDING CORPORATION
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2011

NOTE 1 – THE CORPORATION

The Educational Enhancement Funding Corporation (“EEFC”) is a special purpose corporation, organized under the South Dakota Codified Laws (Chapter 5-12). EEFC is an instrumentality of, but separate and apart from the State of South Dakota (the “State”). EEFC is governed by a board of directors that consists of nine members appointed by the Governor. Although legally separate from the State of South Dakota, EEFC is a component unit of the State and, accordingly, is included in the State’s financial statements.

Pursuant to a Purchase and Sale Agreement with the State, the State sold to EEFC all of its future right, title and interest in the Tobacco Settlement Revenues (“TSRs”) under the Master Settlement Agreement (“MSA”). The MSA resolved cigarette smoking-related litigation between the settling states and the Participating Manufacturers (“PMs”), released the PMs from past and present smoking-related claims, and provides for a continuing release of future smoking-related claims, in exchange for certain payments to be made to the settling states, as well as certain tobacco advertising and marketing restrictions, among other things. The purchase price of the State’s future right, title and interest in the TSRs has been financed by the issuance of the Bonds and the Residual Certificate. The Residual Certificate represents the right of the State to receive all amounts required to be distributed after payment of all outstanding bonds and other liabilities of EEFC as set forth in the Trust Indenture. Pursuant to the resolution EEFC is prohibited from selling additional bonds, other than refunding bonds. The Bonds represent limited obligations of EEFC, payable solely from and secured solely by the pledged TSRs and the pledged amounts. The Bonds are not a debt or liability of the State or of any political subdivision or agency thereof. EEFC has no taxing power.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting. The EEFC is reported on the accrual basis of accounting. Revenue is recognized in the accounting period in which it is earned and expenses are recognized when they are incurred. The EEFC follows all Governmental Accounting Standards Board (GASB) pronouncements and those Financial and Accounting Standards Boards Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with GASB pronouncements.

Cash and Cash Equivalents. This account includes cash and investments with original maturities of ninety days or less. Cash and cash equivalents reported in the Statement of Cash Flows represent all investments with an original maturity of ninety days or less.

Investments. Investments are reported at fair value. Unrealized gains and losses due to fluctuations in the market value are included in investment income.

Operating and Nonoperating Revenue. The EEFC's single source of operating revenues are the Tobacco Settlement Revenues ("TSRs"). Nonoperating revenue is generated solely by investment earnings. See Note 4 for additional investment disclosure.

Restricted Assets. A Liquidity Reserve Account was established and was maintained by EEFC in an amount equal to the Liquidity Reserve Requirement amount of \$23,422,245. When both restricted and unrestricted resources are available for use, it is the EEFC's policy to use restricted resources first, then unrestricted resources as they are needed.

NOTE 3 – LONG-TERM DEBT

In connection with the purchase of the State's future right, title and interest in the Tobacco Settlement Revenues ("TSRs"), EEFC issued bonds in an aggregate principal amount of \$278,045,000 on September 24, 2002. The EEFC has pledged to bondholders all the accounts established and maintained by the Trustee pursuant to the Trust Indenture. In addition to a debt service reserve and a capitalized interest account, those accounts include the TSRs, net of amounts allocated to the EEFC for operating purposes and to pay arbitrage rebate. The Operating Account and Operating Contingency Account for EEFC are not pledged to bondholders. EEFC applied all TSRs to pay its operating expenses and to the payment of scheduled debt service and turbo redemption bonds. Outstanding bonds payable bear interest at rates ranging from 6.5% to 6.72%, and \$0 of regularly scheduled bonds were redeemed and \$10,985,000 of bonds were turbo redeemed during fiscal year 2011. The balance of bonds outstanding at year end was:

Educational Enhancement Funding Corporation
Bonds Outstanding
As of June 30, 2011

Fiscal Year Ending June 30	Principal	Interest	Total Debt Service
2012	\$ 0	\$ 13,055,892	\$ 13,055,892
2013	0	13,055,892	13,055,892
2014	0	13,055,892	13,055,892
2015	0	13,055,892	13,055,892
2016	0	13,055,892	13,055,892
2017-2021	23,993,000	63,873,838	87,866,838
2022-2026	59,745,000	49,939,044	109,684,044
2027-2031	92,075,000	26,181,025	118,256,025
2032	<u>22,685,000</u>	<u>1,474,525</u>	<u>24,159,525</u>
Total	<u>\$ 198,498,000</u>	<u>\$ 206,747,892</u>	<u>\$ 405,245,892</u>

The following is a schedule of Bonds Payable as of June 30, 2011:

Bond Series	Maturity Through	Interest Rates	Balance 6/30/10	Retired	Balance 6/30/11	Amount Due Within One Year
2002A	2025	6.72%	\$ 79,943,000	\$ 10,985,000	\$ 68,958,000	\$ -
2002B	2032	6.50%	<u>129,540,000</u>	<u>-</u>	<u>129,540,000</u>	<u>-</u>
Total			209,483,000	10,985,000	198,498,000	-
Original issue discount, net of amortization					<u>(1,819,251)</u>	
Bonds payable, net of discount					<u>\$196,678,749</u>	

NOTE 4 – CASH AND INVESTMENTS

All of the EEFC's cash and investments are held and administered by a bank trust department. Separate accounts are maintained for the required Liquidity Reserve Sub-Accounts and other purposes as stipulated in the indentures. All investments are held on behalf of the EEFC by the bank as trustee.

For purposes of reporting cash flows, the EEFC considers all highly liquid investments (maturities of three months or less) and all investments with insignificant risk of changes in

value because of changes in interest rates to be cash and cash equivalents. Cash equivalents are reported at fair value. The balance in this fund as of June 30, 2011 was \$195,672 at fair value.

Deposits:

Custodial Credit Risk. Custodial credit risk is the risk in the event of a bank failure, the EEFC's deposits may not be returned to it. At June 30, 2011 the EEFC had insured deposits with a bank trust department of \$195,672 that were in the bank's name.

Investments:

Custodial Credit Risk. At June 30, 2011 the following investments were uninsured and unregistered, with the securities held by a bank trust department, but not in EEFC's name.

	<u>Fair Value</u>
U.S. Government Agencies Agreement	\$ 9,313,893
Debt Service Reserve Fund Agreement	<u>23,421,566</u>
Total Investments	<u>\$ 32,735,459</u>

Interest Rate Risk. The EEFC does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. The weighted duration (in years) of fixed income investments are listed in the following table.

Investment Type:	<u>Fair Value</u>	<u>Duration in years</u>
U.S. Government Agencies Agreement	\$ 9,313,893	0.93
Debt Service Reserve Fund Agreement	<u>23,421,566</u>	20.94
Total Investments	<u>\$ 32,735,459</u>	
Total Portfolio Duration		15.24

Credit Risk. The EEFC does not have a formal investment policy with respect to credit risk. As of June 30, 2011, the investment of the Liquidity Reserve Account was subject to a Debt Service Reserve Fund Agreement among the EEFC, The First National Bank in Sioux Falls, as trustee for the bonds, Morgan Stanley & Co. Incorporated ("MSCI") and Morgan Stanley Capital Services, Inc. ("MSCS"). So long as such securities are available on the open market, the agreement obligates MSCI to purchase and deliver certain investment securities on a semiannual basis to the trustee for the bonds at a price resulting in a fixed rate of return of 4.606%. MSCS has agreed to make payments to provide a guaranteed rate of return of 4.606% under the agreement (such obligation of

MSCS relates to the delivery of securities at the required yield, but does not extend to the payment of principal required with respect to the underlying securities). On May 31, 2011 Morgan Stanley delivered Scaldis Capital commercial paper in the amount of \$23,421,566 to yield 4.606%. The investment securities to be purchased and delivered by MSCS under the agreement are required to satisfy one of the following three criteria (i) either be payable on demand or mature within 190 days and be rated at least A-1+ /P-1, (ii) consist of obligations of the United States government or (iii) consist of notes, bonds or other securities issued or guaranteed by designated agencies of the United States of America, provided that such notes or bonds described in this clause are required to be rated in the highest long-term rating category of S & P and Moody's. The agreement matures on June 1, 2032 or earlier upon redemption of all bonds or if EEFC exercises its optional termination right. The June 30, 2011 ratings of Scaldis Capital were A-1+ by Standard and Poor's and P-1 by Moody's.

All investments other than those in the Debt Service Reserve Agreement are either obligations of U.S. Government Agencies or Goldman Sachs Financial Square Treasury Instruments Fund. The obligations of U.S. Government Agencies were rated AAA by Standard and Poor's at June 30, 2011. The Goldman Sachs Financial Square Treasury Instruments Fund was rated AAAM by Standard and Poor's and Aaa-mf by Moody's at June 30, 2011.

Concentration Credit Risk. The EEFC places no limit on the amount the corporation may invest in any one issuer. More than 5 percent of the EEFC's investments are in an investment agreement and U.S. Government Agencies. These investments are 71.6% and 19.9%, respectively, of the EEFC's total investments.

NOTE 5 – DEFICIT BALANCE

Generally accepted accounting principles require disclosure of net deficit balances at year end. As of June 30, 2011, the statement of net assets reports a deficit balance of \$149,551,585.

Reason

The EEFC issued long-term debt in order to purchase the Tobacco Settlement Revenues ("TSRs") from the State. The debt is shown on the statement of net assets as a liability of EEFC. The TSRs will be used to repay this debt. A receivable based on an estimate of known sales by participating manufacturers for the first six months of calendar year 2011 to be received in calendar year 2012 is shown on the statement of net assets as an asset of EEFC; however, no receivable for future payments from participating manufacturers has been recorded or reported due to the uncertainty of the exact amounts or the timing of future receipts.

NOTE 6 – COMMITMENTS AND CONTINGENCIES

Contingency 1. The EEFC purchased future Tobacco Settlement Revenues ("TSRs") from the State of South Dakota by issuing long-term bonds. The future collection of the TSRs will be used to pay the debt service of the EEFC. As stated in Note 5, no receivable for future payments is recorded or reported.

Contingency 2. South Dakota received only a portion of its expected April 15, 2011, annual MSA payment, in part due to a dispute with certain Participating Manufacturers over the applicability of a downward Nonparticipating Manufacturer ("NPM") Adjustment. The NPM Adjustment procedure is found in Section IX(d) of the Master Settlement Agreement ("MSA").

A state will not be subject to an NPM Adjustment for a particular year if it is found to have "diligently enforced" its Qualifying Statute throughout that year. South Dakota's litigation against the Participating Manufacturers regarding the 2003 NPM Adjustment, commenced in 2006, is still pending at this time, as part of a nationwide arbitration involving the Participating Manufacturers and virtually all the MSA Settling States.

In that arbitration South Dakota recently learned that its "diligent enforcement" for the year 2003 is no longer contested. Thus, South Dakota will not be subject to a 2003 NPM Adjustment. Presumably, amounts that the Participating Manufacturers withheld from the states or placed into a disputed payment account with regard to the 2003 NPM Adjustment will not be disbursed until the nationwide arbitration is concluded. It is anticipated that litigation over the NPM Adjustment for 2004 and thereafter will follow.

Several Participating Manufacturers reduced their April 15, 2011 annual MSA payments to the states, either withholding a portion of the payment or placing the disputed amount into a disputed payment account. Again, it is anticipated that these amounts will not be disbursed to the states until the dispute is resolved with finality.

Likewise, the states expect that several Participating Manufacturers will seek a downward Nonparticipating Manufacturer Adjustment with respect to the annual MSA payment due to the states in April 2012. As in the past, the Participating Manufacturers might withhold the disputed amount or place it in a disputed payment account until the issue is resolved. Whether such a reduction will be made, and if so, the amount of the reduction, is not known at this time.

NOTE 7 – RISK MANAGEMENT

The EEFC is exposed to various risks of loss related to officers' and directors' errors and omissions. These risks are covered through the purchase of Directors' and Officers' insurance with a liability limit of \$5,000,000 and a retention limit of \$250,000.

NOTE 8 – SUBSEQUENT EVENT

On September 8, 2011 Moody's Investor Services upgraded the Series 2002A Taxable Bonds and the Series 2002B Tax Exempt Bonds from Baa3 to A1 and A3, respectively.